2004 Financial Management Seminar

December 1 - December 3, 2004

Monterey Conference Center
Monterey, California

The California Debt and Investment Advisory Commission

Welcomes You To

ABCs of Debt Financing

2 December 2004

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Section 1

Introduction

CDIAC's Mission

"To improve the practice of public finance in California by providing responsive and reliable information, education and advice"

CDIAC Programs

- Data Collection
- Educational Programs
- Policy Research
- Technical Assistance

CDIAC Data and Information

- Debt Issuance Database
  - Report of Proposed Debt Issuance and Final Sale
- DEBT LINE
  - Calendar of Issues
  - Monthly Report on Debt Issuance
  - State Legislation Update
- Mello-Roos CFD and Marks-Roos Bond Pooling Draw on Reserves/Default Reports
- Data on Disk – Yearly and Monthly Debt Statistics
- Yearly Report on Debt Issuance Volume

Current CDIAC Research Areas

- Federal Securities Disclosure Law
- Financing Innovations
- State and Municipal Financing Legislation
- Land Based Financing
- Derivative Products

CDIAC Provides Guidelines and Policy Papers

- Debt Issuance/ Investment Primer
- Disclosure for Land Based Financings
- Local Agency Investment Guidelines (2003 Update)
- Understanding Public Investment Reporting: A Handbook for Local Elected Officials
- Electronic Disclosure Issue Brief
- Investing in Callable Securities Issue Brief
- Reimbursements and Bond Proceeds
- Tools to Revitalize California Communities

Upcoming CDIAC Seminars 2005

Schedule		
Understanding Municipal Securities Disclosure Symposium	February 2005	Los Angeles
Investing Public Funds: Fundamentals of Managing Your Portfolio	March 2005	Oxnard
CDIAC at CMTA – Auction Rate Securities and Finding Value in Investment Portfolios in Current Market	February 24, 2005	Burlingame
Advanced Debt Management Seminar	May 2005	Pasadena

Overview of the Financing Process

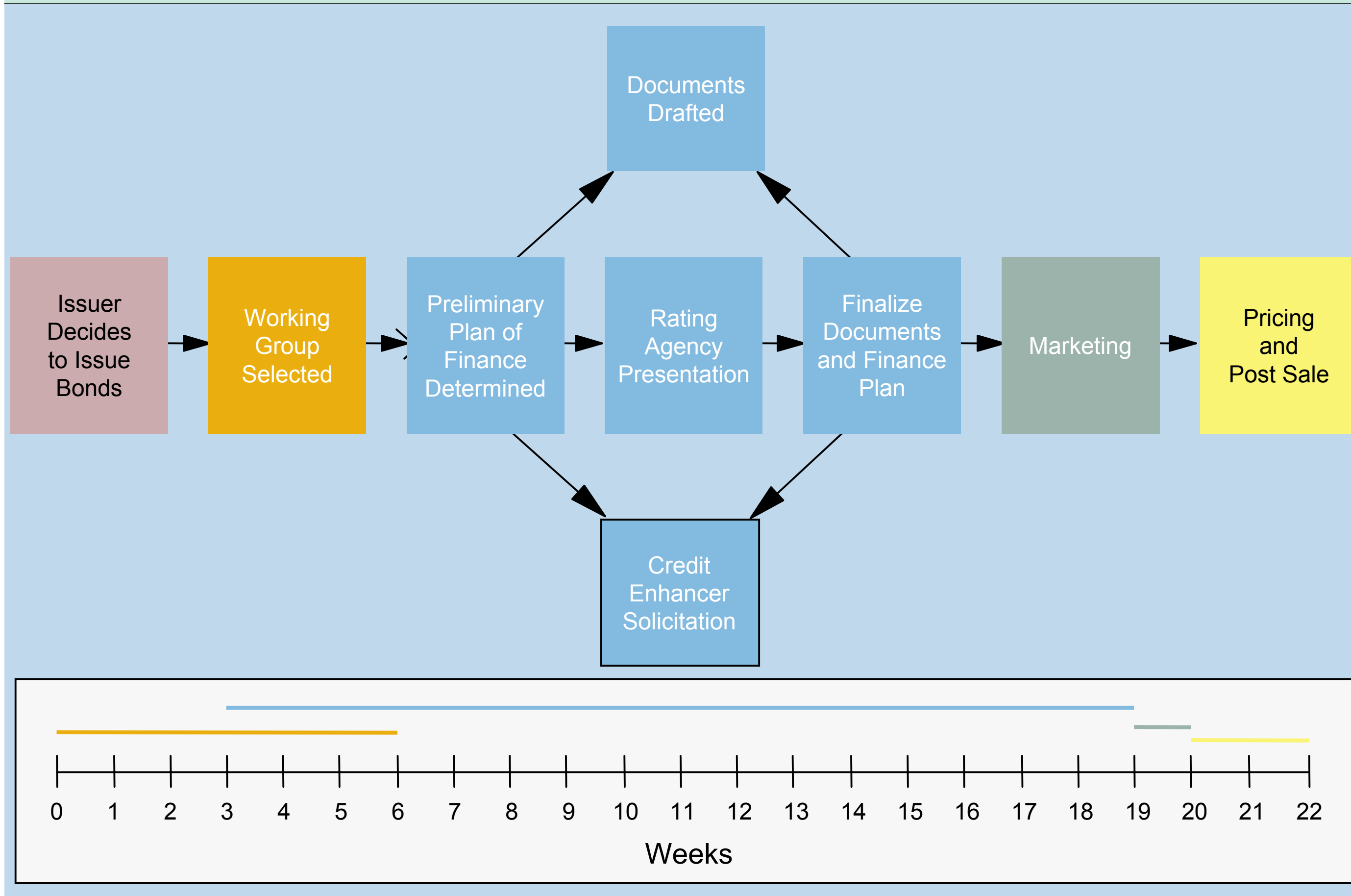
Debt issuance can be complex and lengthy

Regulatory environment

Sarbanes-Oxley Act implications

Post-issuance management increasingly important

Transaction Timeline



Section 2

Establishing Prudent Debt Management Policies

Policy Elements

- Define the purposes for public borrowing
- Link debt issuance to CIP budget management
- Establish borrowing capacity criteria
- Ensure preservation of agency assets and its credit ratings
- Identify types of debt and criteria for their issuance
- Establish collateral requirements and risk tolerance levels
- Affirm adherence to ethical and regulatory debt management practices
- Document criteria for selection of finance professionals

Purposes of Public Borrowing

Meet essential capital and infrastructure needs

Maintain health and safety standards

Preserve quality of life and community interests

Pay for long-term assets over useful life – cost/benefit allocation

Cash flow borrowings

Financing Purpose

New Money

- Large scale capital projects
- Bridge the gap on timing between expenditures and revenues

Refunding

- Refinance old debt with new bonds at a lower all-in borrowing cost (economic refunding)
- Refinance old debt with new bonds to restructure debt service payments that satisfy a new need and/or eliminate/replace covenants imposed on old bonds (may or may not be an economic refunding)

Link to CIP Budget Management Process

- Refine fiscal forecast
- Nexus with Operational Budget
- Update and Modify the Capital Improvement Program

Establishing Borrowing Capacity Limits

- Debt as a percentage of Assessed Valuation
- Debt per capita
- Effective Tax Rate Burden
- Special Revenue Bond Limits

Ensure Preservation of Agency Assets/Credit Rating

- Local economic analysis
- Internal agency review
  - Fiscal forecast
  - Maintenance of CIP
  - Disclosure compliance
  - Long range strategic planning
  - Reserve policy

Establishing Collateral/Risk Tolerance Levels

- Lien to value ratios
- Thresholds for purchasing bond insurance
- Effective Tax Rate
- Letter of credit requirements
- Debt to Assessed Value ratios

Adherence to Ethical & Regulatory Debt Practices

- Legal requirements for issuance
- Disclosure requirements (Rule 15c 2-12)
- G38–MSRB–Gifting
- GAAP
- IRS Arbitrage/Rebate requirements
- FPPC Conflict of interest standards

Document Criteria for Selection of Finance Professionals

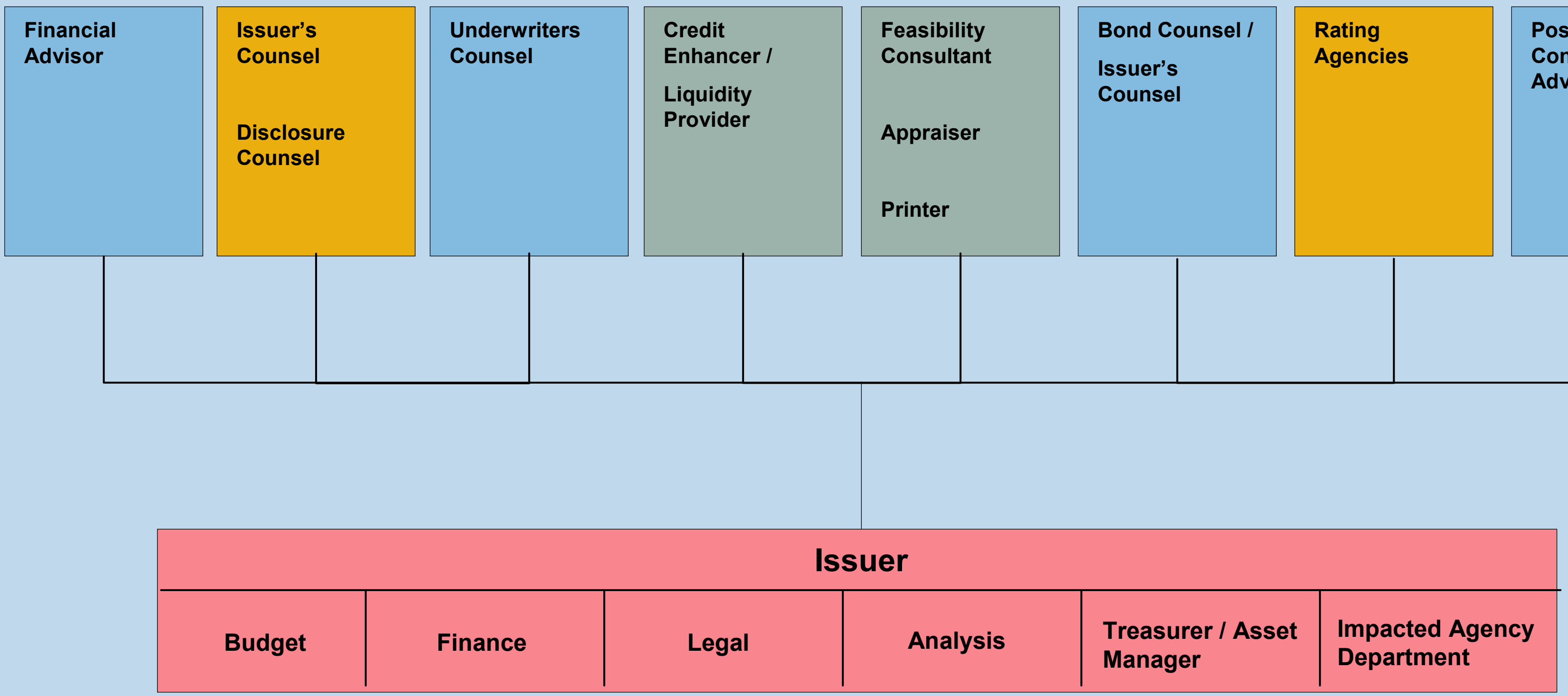
- Governing Board–Delegation of authority
- Requests for Information, Qualifications, Proposals
- Use of JPA's/Pooled assets/Private Placement
- Retainer for FA
- Cost Factors

Section 3

Financing Team Composition and Selection

Potential Financing Team Members

Potential Financing Team Members



Financial Advisor

- Annual credit ratings presentation
- Refunding analyses
- Financing options for new projects
- Structuring a Capital Improvement Program
- New product and proposal reviews

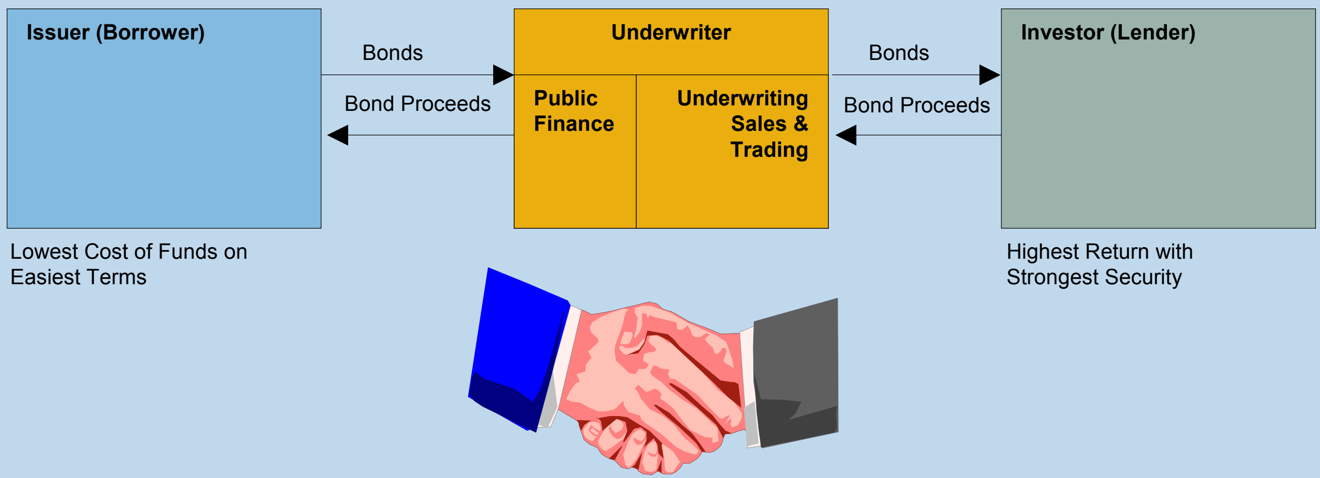
What is "Underwriting?"

Intermediation of Risk Between Issuer and Investor

- Underwriting is the intermediation of risk between issuer and investor
- Other non-financial examples of underwriting are Insurance and Broadway Productions

What is "Underwriting?"

Intermediation of Risk Between Issuer and Investor



Role of the Underwriter

Public Finance

- Solicits and negotiates new business
- Develops financing alternatives
  - Type of debt
  - Structure of issue
  - Credit/security
- Assists in drafting of bond and disclosure documents
- Develops rating agency strategy and presentations

Underwriting, Sales & Trading

- Educates market and solicits investor interest
- Manages pricing process
- Sells bonds to investors and provides proceeds at closing
- Risks capital
- Maintains orderly ongoing secondary market, research and
- Analytical support

To Whom Does the Underwriter Sell Bonds?

Retail Buyers

- High-Net-Worth Individuals
- "Mom and Pop" Buyers

Institutional Buyers

- Bond Funds
  - Money Market Funds
  - Mutual Funds
  - Closed-end Funds
  - Unit Trusts (UITs)
- Insurance Companies
- Corporations
- Bank Trust Departments
- Crossover Buyers

Section 4

Basic Debt Structures and Bond Types

What Are Bonds?

- A bond represents a formal contract between the borrower and lender on the terms and conditions of a loan between the parties
- A bond is not ownership in a business, a piece of property or anything else (with the exception of convertible bonds in the corporate bond market)
- Bondholders are creditors and expect to be paid back both the money lent, called *principal*, and additional payment for the use of the money, called *interest*
- Bondholders serve a similar lending function as banks; the difference is that the investor or bondholder is the direct lender to the borrower rather then an indirect lender through a bank intermediary
- Decision of a borrower to access the public market vs. a bank depends on many factors including borrowing amount, relative transaction costs, relative timing issues, differences in restrictions or covenants imposed on the borrower and market rates

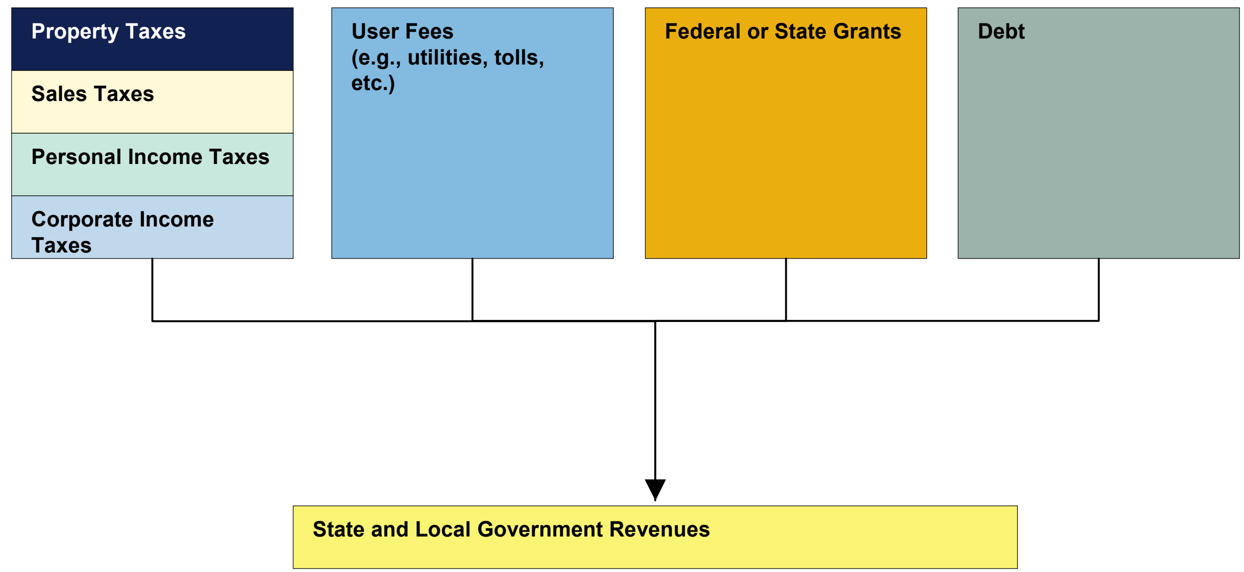
Some Variations of Municipal Bonds

Some Variations of Municipal Bonds	
Issuers	State Governments
	Local Governments
	State and Local Authorities and Agencies
	Native American Tribes
	Tax-Exempt Districts
	501 (c)(3) Non-Profits (Hospitals, Universities, Museums)
Sale	Competitive: lowest price of sealed bids by investment banks
	Negotiated: price negotiated by senior manager and issuer
Credit	General Obligation Bonds
	Revenue Bonds
	Special Facility Bonds (secured by usage surcharges)
Length of Debt	Long Term (Bonds): maturities longer than 1 year but not beyond 30 or 40 years
	Short Term (Notes): maturities usually not longer than 1 year
Interest Rate Mode	Fixed Rate: set at time of initial pricing
	Variable Rate: reset on daily, weekly, monthly or periodic basis

Sources of Money to Fund Expenditures

Income, Balance Sheet and Cashflow Statement of Government Entities

States and many local governments have the power to raise taxes and use the tax revenues for whatever use they deem appropriate



How Do Municipal Bonds Differ From Other Bonds?

- Bonds issued by state and local governments and authorities – municipal bonds – enjoy a special tax-exempt status when issued for certain public purposes
- The interest income that investors receive on their municipal bond investment is exempt from federal taxation and often from state and local taxes
- As a result, investors are willing to accept a lower interest rate than they would if their income was taxable
- This results in a "subsidized loan" to the issuer; the government agrees to forego money in tax revenues, and the issuer enjoys a lower interest rate on its debt
- In general, only capital projects can be financed through tax-exempt debt
  - Only under certain circumstances can working capital be funded in this manner
- The types of projects that may be financed and how bond proceeds are spent are subject to very specific tax law constraints which may greatly influence the financing structure and process

Bond Components

Bond Components	
Issuer	Either the borrower of a state or local government entity or a conduit for qualified 501(c)(3) and other non-government entities
Par Value	The principal amount promised to be repaid upon maturity. Typically expressed as 100%
Maturity Date	The date principal will be repaid
Interest Rate or Coupon	The annualized percent of principal an investor will receive as compensation for lending money
Interest Day Count Basis	The convention used to calculate the number of days and/or proportion of interest owed since the last interest payment date. Typically, the municipal market uses a 30/360 day count basis for fixed rate transactions and an Actual/Actual basis for variable rate transactions.
Denominations	Typically, minimum of $5,000 and any multiple thereof for a fixed rate transaction and minimum of $100,000 and any integral multiple of $5,000 thereof
Dated Date	Date interest starts to accrue
Delivery Date	Date of settlement (i.e. payment exchanged for bonds)
Next Coupon / Coupon Payment Dates	Dates in which interest is payable
Paying Agent	The bond / entity to which coupons should be presented for payment
Trustee	The bond / entity that ensures the timely receipt of debt source payment from the borrower and payment to the issuer
Call Feature	Any optional redemption provisions, such as a 10-year call at par at the discretion of the borrower. Any mandatory redemption provisions such as showing fund redemptions. Any extraordinary redemption provision that would require the defeasance of the bonds
Legal Opinion	Certification from Bond Counsel that it is of the opinion of Counsel that the bonds are exempt from Federal, State and Local Income Tax. The opinion will also state where the interest is included in the calculation of AMT (alternative minimum tax)

Long-Term Term Financing Options

Fixed vs. Variable Rate Debt

	Pros	Cons
Fixed Rate Bonds	• Future credit and rate risk shifted to investors • Most common form of tax-exempt debt • Budget certainty • Ability to enter into a fixed-to-floating rate swap and gain some benefits of variable rate market without some of the risks	• Historically higher cost • Potentially expensive to restructure • Typically not callable for 10 years • Little flexibility for borrower once the bonds are issued
Variable Rate Bonds	• Typically callable on any interest payment date at par • Historically lower rates than fixed rate debt • More efficient use of the yield curve - no premium built in for tax risk • Ability to enter into floating-to-fixed rate swap to manage variable rate exposure and take advantage of market conditions • Natural hedge results from short-term investments/operating cash	• Interest rate risk • Remarketing / liquidity risk • Element of budget uncertainty resulting from potential rate volatility

Long-Term Financing Options

Variable Rate Financing Options

Product	Description	Advantages	Disadvantages
Multi-Modal Variable Rate Demand Bonds (VRDBs)	• VRDBs are remarketed at new interest rates on a periodic basis (daily, weekly, etc.). Issued with bond insurance and a bank liquidity facility or a letter of credit • Investors may put the bonds back at par on each reset date • Bonds are sold with a nominal long-term maturity	• Allows long-term financing with short-term rates • Low cost of capital, assuming the liquidity fees stay at the low end of the range • Potential for pre-payment requirement	• Liquidity and remarketing fees are subject to change • Banks in the same rating category may trade differently as a result of 2(a)(7) regulations on capacity issues • Ongoing management necessary • Ongoing interest rate, tax and remarketing risk
Auction Rate Notes	• Interest rates are reset through a modified Dutch Auction periodically (e.g., 7, 28, 35 days) • Auction Rate Notes do not have a put provision • Bonds are sold with nominal long-term maturity	• Allows long-term financing with short-term rates • No put risk or pre-payment required • Typically sold to retail and high-net-worth investors	• Auction can fail if there are more sellers than buyers • More limited buyer base • Ongoing interest rate, tax and auction risk

Long Term Financing Options

Synthetic and Other Alternatives

"Synthetic" liabilities can provide a lower cost of funds and/or accomplish other financing objectives

Morgan Stanley and client must assess credit, basis, rate, counterparty and other risk factors before qualifying on opportunity

- Floating to fixed rate swap
- Fixed to floating rate swap
- Investor-driven products (e.g. CPI bonds)
- Forwards
  - forward delivery bonds
  - forward swaps
- Rate Locks

Short Term Financing Options

- **Securities generally under 1 year maturity used to bridge gaps between revenues and expenditures**
- **When notes mature, a new set of notes may be issued if the anticipated source of repayment does not materialize**
  - **continued practice of "rolling over" notes would have a negative impact on ability to finance in the future**

Short Term Financing Options

Type	Description
Bond Anticipation Notes ("BANs")	Notes issued in anticipation of an issue of bonds. The notes will be repaid once the bonds are sold
Tax Anticipation Notes ("TANs")	Notes issued in anticipation of the receipt of taxes which will be used to repay the notes when received
Revenue Anticipation Notes ("RANs")	Notes issued in anticipation of the receipt of revenues, which will be used to repay the notes when received
Tax-Exempt Commercial Paper ("TXCP")	TXCP is a short-term instrument with maturities up to 270 days. Often used in place of notes by large issuers to finance short-term needs or as a means of financing continuing construction or development projects. Periodically, the TXCP is repaid with long-term bonds as necessary. Set up as a program intended to be used as a permanent source of financing (by rolling over TXCP) as opposed to notes.

Section 5

Understanding the Legal Documents

Primary Documents

Summary Descriptions of Legal Documentation

Legal Documentation

Documents	Parties	Purpose	Typical Preparation
Bond Resolution or Indenture (Lease Agreements)	Issuer Issuer and Trustee	Sets forth security provisions and covenants with which borrower must comply; authorizes general issuance of debt; sets forth parameters under which bonds can be issued, flow of funds, pledge of revenues, types of permitted investments and events of default and remedies	Bond Counsel
Series Resolution or Supplemental Indenture	Issuer Issuer and Trustee	Sets forth specific features (amounts, maturities, and redemption features)	Bond Counsel
Loan Agreement (if "conduit" issue – proceeds loaned to another entity such as a college/university hospital, corporation)	Issuer and Borrower	Provides for loan of bond proceeds to borrowing entity; sets forth covenants with which borrower must comply	Bond Counsel
Bond Purchase Agreement	Underwriter and Issuer	Governs purchase of bonds, provisions for underwriter "outs" and stickers and conditions of closing	Underwriter's Counsel
Preliminary Official Statement (POS or Red Herring)	Issuer	Provides information on security, purpose of issue, background on issuer (and borrower); used to market bonds to potential investors; provides means of disclosure The draft version of the Official Statement which is mailed by the issuer or underwriters to determination of prices and interest rates. The primary selling and disclosure document, it contains in-depth information concerning the issuer, the proposed financing's terms and structures and other relevant background information. A statement that no offer for or acceptance of bonds can occur on the basis of the POS is made in red on the left of the cover, thus causing it be known as the Red Herring.	Underwriter's Counsel
Final Official Statement (OS)	Issuer	Final Version of POS; includes final rates, maturities, sinking fund payments and redemption provisions, continuing disclosure certification, specimen bond	Underwriter's Counsel

Primary Documents *(continued)*

Summary of Description of Legal Documentation

Legal Documentation			
Document	**Parties**	**Purpose**	**Typical Preparation**
Arbitrage Certificate, IRS Form 8038	Issuer	Sets forth restrictions on use of proceeds and compliance with arbitrage/rebate provisions; describes flow of funds	Bond Counsel
Underwriters Agreement	Among Underwriters	Establishes the rights, duties and commitments of the members of an underwriting syndicate for a new issue of securities	Underwriter's Counsel
If Credit Enhanced: Insurance Policy, Letter of Credit or Standby Bond Purchase Agreement	Credit Enhancer	Provides additional security from third party	Counsel to Credit Enhancer
If Variable Rate Bonds: Remarking Agreement	Underwriter and Issuer	Sets forth remarketing fees, qualifications and duties of remarketing agent	Underwriter's Counsel
Legal Opinions: Bond Counsel Opinion Opinions of Issuer; Borrower's Counsel (if any), Underwriter's Counsel, Credit Enhancer's and Trustee's Counsel	Bond Counsel	(1) Opinion on tax-exemption on bonds and due authorization of bond issuance (2) Opinion as to the authorization of legal documentation, exemption from registration and 10(b)(5) opinion on certain sections of OS (correct and no omissions of material facts) Sets forth due authorization of applicable parties to enter into agreements, validity and good standing of entity; 10(b)(5) opinion on certain sections of OS	Bond Counsel
Miscellaneous: Various Certificates of Issuer, Trustee, Borrower, Credit Enhancer and Underwriter; Cross Receipts for Bonds/Proceeds; Rating Letters; Specimen Bonds; Comfort Letter (if applicable); Blue Sky and Legal Investment Summary, CDIAC			

Resolutions of Issuer

- Resolution of Issuance
- **Numerous preliminary documents**
  - Based on type of issue
  - May require Prop 218 vote
  - Land based financing – specific requirements
  - COP/Lease Revenue Bond specific requirements

Section 6

Post-Issuance Debt Management

Issuer Responsibilities

- Establish working relationship with Trustee
- Ensure internal check/balance with General Ledgers and Trustee accounts
- Comply with all disclosure requirements
- Provide Trustee financial statements and budgets
- Ensure construction drawdowns in accord with invested proceeds
- Analyze markets to determine refinancing options
- Ensure annual arbitrage/rebate review is completed
- Perform all required bond calls
- Recast debt service schedules when required
- Ensure payment of all professional service fees
- Ensure deletion of pre-paid special assessment from tax rolls
- Process all signature changes resulting from personnel adjustments
- Ensure all required insurances are updated
- Analyze restructuring options
- Coordinate preparation of annual Financial Statement to reflect accurate annual debt obligations

Post-Issuance Debt Management

Consequences of Failure

- Lost opportunity for refinancing
- IRS sanctions
- Default conditions requiring disclosure
- Investor Lawsuits
- Credit rating downgrades
- Reduced access to capital markets